

Internal Revenue Service
memorandum

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JSRoss

date:

MAR 24 1987

to:

District Counsel, Kansas City, MO. CC:KCY

from:

Director, Tax Litigation Division CC:TL

subject:

This is in response to your memorandum dated January 13, 1987 recommending the concession of an award of litigation costs in the above-captioned case.

ISSUES

(1) Whether the issuance of a statutory notice of deficiency to petitioner is subject to review under I.R.C. § 7430(c)(4)(B) for purposes of determining whether petitioner is entitled to an award of litigation costs.

(2) Whether petitioner exhausted his administrative remedies within the meaning of section 7430(b)(1) where he chose to send the Service an explanatory letter in response to the 30-day letter rather than requesting an Appeals office conference.

CONCLUSIONS

(1) Under section 7430(c)(4)(B), added by the Tax Reform Act of 1986, the "position of the United States" upon which a claim for litigation costs may be brought includes "any administrative action or inaction by the District Counsel of the Internal Revenue Service (and all subsequent administrative action or inaction) upon which such proceeding is based." This office is currently taking the position that unless District Counsel reviewed the statutory notice of deficiency or was involved in a case at the administrative level, there is no prelitigation position subject to scrutiny under the "not substantially justified" test of section 7430(c)(2)(A)(i). Under this interpretation, the issuance of the statutory notice of deficiency in this case is not an action upon which a claim for litigation costs under section 7430 may be based. However, in light of prior informal advice from this office that this issue should be conceded, it is inappropriate to contest the motion for litigation costs in this case.

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(2) The regulations under section 7430 provide that, where a party receives a 30-day letter, the party will not be considered as having exhausted its administrative remedies unless it requests an Appeals office conference. Treas. Reg. § 301.7430-1(b)(1)(ii). Because petitioner herein responded to the 30-day letter by sending an explanatory letter to the Service Center (option (1) outlined in the 30-day letter), and did not request an Appeals office conference (option (3) in the 30-day letter), he did not satisfy the requirement of the regulations. However, because the 30-day letter in this case specifically requested that petitioner elect option (2), this case is not an appropriate litigating vehicle with respect to the exhaustion of administrative remedies issue.

FACTS

The adjustments in this case involve various items of interest and dividend income. The 1099 matching program disclosed discrepancies in petitioner's [REDACTED] individual income tax return, and on [REDACTED], the Austin Service Center contacted petitioner by letter and asked for an explanation of the discrepancy. On [REDACTED] petitioner wrote a letter to the Service Center, explaining that he had never owned stock in [REDACTED] (a \$[REDACTED] item), that a \$[REDACTED] item was in fact reported on the return, and that all other items were properly reported on the fiduciary income tax return of his wife's estate. On [REDACTED], the Service Center acknowledged receipt of the explanation and stated that a reply would be given within 45 days.

On [REDACTED], the Service Center sent petitioner a 30-day letter, stating that "we have no record of receiving a reply to our previous letter." The letter offered petitioner three alternatives:

- (1) Mail additional information for consideration,
- (2) Request a meeting with an examiner, or
- (3) Request an Appeals conference.

However, after explaining option (3), the letter stated: "However, since the examination was conducted entirely by mail, we would appreciate your first discussing our findings with an examiner, as explained in item 2."

On [REDACTED], petitioner wrote back to the Service Center offering additional information and enclosing copies of the previous correspondence. On [REDACTED], the Service Center acknowledged receipt of the [REDACTED] correspondence, and stated that a reply would be made within 45 days.

On [REDACTED], the Service Center mailed a notice of deficiency to petitioner. The petition in the Tax Court was filed on [REDACTED]. In respondent's answer, most of petitioner's allegations concerning the above were denied for lack of information, because the administrative file did not contain the correspondence at that time. The case was sent to Appeals for consideration. After receiving copies of the returns and correspondence, the Appeals officer on [REDACTED] recommended that the case be conceded in full.

DISCUSSION

(1) Section 7430(c)(4): "Position of the United States"

Section 7430, enacted by the Tax Equity and Fiscal Responsibility Act of 1982, authorizes the award of reasonable litigation costs to a taxpayer who prevails in a tax controversy with the government in any Federal court. Section 7430 contains a number of requirements that a taxpayer must satisfy in order to be awarded litigation costs, some of which were modified by the Tax Reform Act of 1986. Under the 1986 amendments, applicable herein, in order to be entitled to an award of litigation costs a taxpayer must establish that "the position of the United States in the civil proceeding was not substantially justified". Section 7430(c)(2)(A)(i). Under the prior version of the statute, the taxpayer had to show that the position of the government was "unreasonable".

Another change made by the 1986 Act is the addition of a definition of the term "position of the United States." Under the old law, courts were divided as to whether it was proper to examine prelitigation action of the government in determining whether the government's position in the "civil proceeding" was unreasonable. Compare Wasie v. Commissioner, 86 T.C. 962 (1986) (section 7430 inquiry limited to government's position from time litigation commences) with Kaufman v. Egger, 758 F.2d 1 (1st Cir. 1985) (inquiry includes prelitigation action). In an attempt to clarify the issue, Congress added new section 7430(c)(4), which provides:

Position of United States.--The term "position of the United States" includes--

(A) the position taken by the United States in the civil proceeding, and

(B) any administrative action or inaction by the District Counsel of the Internal Revenue Service (and all subsequent administrative action or inaction) upon which such proceeding is based.

In order to be entitled to litigation costs, a taxpayer must, as a threshold matter, demonstrate that the governmental action in question falls within the definition of "position of the United States." There is no question that the governmental action after the filing of the petition is subject to scrutiny under section 7430. However, it is equally clear in this case that the Appeals officer's action in obtaining the necessary information to substantiate that the return was correct, and promptly thereafter conceding the case, leaves no basis for an argument that the litigating position was "not substantially justified." See Harrison v. Commissioner, T.C.M. 1987-52; Zielinski v. United States, 54 AFTR 2d 84-5132, 84-1 USTC 9514 (D. Minn. 1984); Eidson v. United States, 53 AFTR 2d 84-841, 84-1 USTC 9182 (N.D. Ala. 1984).^{1/}

Given that the post-petition government action in this case was clearly substantially justified, the critical language becomes the phrase "any administrative action or inaction by the District Counsel of the Internal Revenue Service" in section 7430(c)(4)(B). Only if petitioner demonstrates that the prelitigation government action falls within section 7430(c)(4)(B) does the statutory analysis proceed to the next step: whether the position of the government was not substantially justified.

This office is currently taking the position that unless District Counsel was involved in a case at the administrative level, there is no prelitigation administrative action subject to scrutiny under section 7430(c)(4)(B). This position is based on a literal reading of the statutory language, which plainly specifies that the first relevant prelitigation action or inaction is that taken "by the District Counsel." Thus, in a case such as this, where District Counsel had no involvement in the administrative process and did not review (or decline to review having had an opportunity to do so) the statutory notice of deficiency, it is our position that the issuance of the notice of deficiency and the underlying administrative action are beyond the scope of section 7430; the issuance of the statutory notice occurred prior to any "action or inaction of the District Counsel." Thus, the only governmental action subject to scrutiny under the "not substantially justified" test is the action following the filing of the petition in the Tax Court.

^{1/} Although these cases were decided under the reasonableness standard of the pre-1986 statute, it has been held that the test of whether a government action is "substantially justified" is essentially one of reasonableness. See Baker v. Commissioner, 83 T.C. 822, 828, vacated and remanded on another issue, 787 F.2d 637 (D.C. Cir. 1986), and cases cited therein.

Our position is further supported by the legislative history of the 1986 amendments to section 7430. The Senate version of the bill contained broader language regarding the application of the "not substantially justified" standard to prelitigation action. The Senate version would have applied the standard to "prelitigation actions or inaction of Government agents." The language agreed upon in conference is much narrower, limiting the prelitigation application of the statute to situations in which District Counsel is involved. Congress clearly rejected the broader Senate provision in favor of a more restrictive provision. To interpret section 7430(c)(4)(B) as applying to a broader spectrum of prelitigation action would in effect be rewriting the statute to enact the Senate's version.

Were [REDACTED]'s petition in Tax Court to be filed today, we would recommend that you contest any motion for litigation costs on the basis of the interpretation of section 7430(c)(4)(B) discussed above. On these facts, the issuance of the notice of deficiency and the underlying administrative action do not constitute a "position of the United States" and thus are not subject to scrutiny under the "not substantially justified" standard. However, at the time of our informal advice to you that the litigation costs in this case should be conceded, this office had not yet established its position on this issue. In light of the fact that our willingness to concede this issue was communicated to petitioners, we determined that it would be inappropriate to contest the motion for litigation costs in this particular case.

(2) Exhaustion of Administrative Remedies

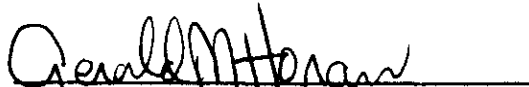
A judgment for litigation costs under section 7430 will not be awarded unless the taxpayer has exhausted the administrative remedies available within the Internal Revenue Service. Section 7430(b)(1). The regulations specify what action a taxpayer must take to exhaust its administrative remedies. In a case such as this, a taxpayer will not have exhausted its administrative remedies unless, prior to the issuance of a notice of deficiency, it requests an Appeals conference, files a written protest if necessary to obtain an Appeals conference, and agrees to extend the time for assessment of tax if necessary to provide the Appeals office with reasonable time to consider the matter. Treas. Reg. §§ 301.7430-1(b)(ii); 301.7430-1(g), ex. 12. But see Minahan v. Commissioner, 88 T.C. No. 23 (March 5, 1987). In that case, the Tax Court held that paragraphs (b)(1)(i)(B) and (f)(2)(i) of section 301.7430-1 are invalid insofar as they require a taxpayer to extend the statute of limitations.

The petitioner in this case responded to the 30-day letter in accordance with the first option provided in the letter, by submitting a written explanation of why the alleged understatement of dividend income was incorrect. Petitioner did not request, in accordance with the third option provided in the 30-day letter, an Appeals office conference. Having failed to request an Appeals conference as required by the regulations, petitioner has not exhausted his administrative remedies. However, because the particular 30-day letter in this case specifically requested that petitioner request a conference with an examiner, rather than an Appeals conference, we agree with your conclusion that contesting this case on the basis that petitioner failed to exhaust his administrative remedies would not be an appropriate litigating strategy. Should you encounter similarly worded 30-day letters in connection with claims for litigation costs in the future, we would appreciate your bringing them to our attention.

We understand that, in accordance with oral advice from this office, a stipulation conceding the award of litigation costs in this case has been filed with the Tax Court. While we advised such concession in this case, the above discussion clarifies the current position of this office with respect to the 1986 amendments to section 7430 and provides guidance for treatment of such cases in the future. If you have any further questions, please contact Jack Ross of this office at (FTS) 566-3521.

ROBERT P. RUWE

By:


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